No. 10556

In the United States Circuit Court of Appeals for the Ninth Circuit

UNITED NATIONAL CORPORATION, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The only previous opinion in this case is the opinion of The Tax Court of the United States (R. 18–42), reported in 2 T. C. 111.

JURISDICTION

This petition for review involves federal income taxes for the fiscal year ended June 30, 1939. (R. 3–14.) On January 17, 1942, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency of income tax in the amount of $3,224.86. (R. 3, 11–12.) Within 90 days thereafter and on April 3, 1942, the taxpayer filed a petition with the

then Board of Tax Appeals (now The Tax Court) for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. The final order and decision of The Tax Court of the United States sustaining a deficiency in income tax for the fiscal year ended June 30, 1939, in the amount of $3,324.65 was entered on June 25, 1943. (R. 43.) The case is brought to this Court by petition for review filed August 16, 1943 (R. 43–47), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. This petition seeks to review only part of the deficiency found by the decision of The Tax Court. (R. 45.)

QUESTION PRESENTED

Whether the sum realized by a corporation, upon purchase and retirement of all of its preferred stock at a discount from par value, shall be regarded as part of its accumulated earnings or profits, taxable to the recipient, its sole stockholder, if distributed at such time and in such manner, as to be essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115 (g) of the Revenue Act of 1938.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved may be found in the Appendix, *infra.*

STATEMENT

The taxpayer, United National Corporation, accepts the findings of fact made by The Tax Court. (Br. 2.)

The Tax Court found as follows: Taxpayer was

incorporated under the laws of the State of Washington and is engaged in business as a holding company. (R. 19.) From the beginning of the taxable year, up to September, 1938, taxpayer owned all the outstanding stock of another corporation, Murphey, Favre & Company, hereinafter referred to as Murphey Company,[1] consisting of 1,000 shares of common stock. (R. 19.) Taxpayer first acquired an interest in Murphey Company in December, 1928, and at all times after June, 1932, until September, 1938, was its sole stockholder. (R. 23.) In August, 1928, Murphey Company obtained authorization to issue 2,500 shares of preferred stock at $100 par value; 2,335 shares of this preferred stock were actually issued for a total cash consideration of $233,500. (R. 22–23, 35.) The preferred stock was issued by reason of expansion in business. The zenith in this expansion was reached in 1929, however, and as a result of subsequent substantial decrease in business in the early 1930's, all of the preferred stock was retired (R. 29), as follows (R. 28):

> On June 30, 1929, the Murphey Co. redeemed shares of its preferred stock at a premium over par value in the total amount of $30. On June 30, 1931, the Murphey Co. redeemed shares of its preferred stock at a discount from the par value of the shares in a total amount of $19,558.90. On June 30, 1932, the Murphey Co. redeemed shares of its preferred stock at a discount from the par value of the shares in the

[1] Murphey Company is also a Washington corporation, engaged in the investment banking business in Spokane. (R. 4–5.)

total amount of $830.10. All of the above redemptions were at a net discount of $20,389. Upon redemption said shares were cancelled or retired. The Murphey Co. never traded in its own stock by buying from one customer and selling to another.

Prior to September 6, 1938, some of the officers of Murphey Company, acting in their individual capacity, desired to purchase its outstanding stock from taxpayer. However, they were unable to raise sufficient funds for that purpose. (R. 23.) Accordingly, a plan was developed for the accommodation of taxpayer, whereby taxpayer was enabled to distribute a portion of the accumulated earnings and profits of the Murphey Company to itself, and, after such distribution, to sell the balance of its holdings in the Murphey Company to the proposed vendees at a price which they could pay. (R. 37.) To attain this end, the capital stock of Murphey Company was reduced on September 6, 1938, from 1,000 shares to 250 shares. (R. 26.)

Distribution was then made to taxpayer from the assets of Murphey Company upon the surrender and redemption of 750 out of its 1,000 shares of Murphey Company stock, in the total value of $176,746.55. (R. 26.) After this redemption was effected, taxpayer sold its remaining 250 shares of Murphey Company stock to the Murphey officers for $51,835.16. (R. 26–27.) The Tax Court found as a fact that the distribution by Murphey Company to its sole stockholder, the taxpayer, was essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115 (g) of the Revenue Act of

1938. (R. 28.) In this finding taxpayer acquiesces upon this appeal (R. 45), although it was the principal issue, which taxpaper contested in The Tax Court (R. 19).

Hence, as stated by taxpayer in its petition for review (R. 45):

> The only issue left in the case for determination on appeal is the amount of the accumulated earnings or profits of Murphey, Favre & Co. on the date of the distribution, pursuant to the redemption of the 750 shares of stock.

The Tax Court computed the accumulated earnings and profits of Murphey Company between March 1, 1913, and June 30, 1938, as follows (R. 27):

Income as shown from income tax returns	$608,153.50
Net additional taxable income resulting from audit reviews of returns	1,748.09
Additional nontaxable profit because of retirement of preferred stock at a discount	20,389.00
Total	$630,290.59

On the other hand, during this period Murphey Company disbursed (R. 27):

Cash dividends	$416,192.56
Income taxes	86,612.21
Insurance premiums	10,856.47
Donations	7,114.18
Total	$520,775.42

Thus, the earnings and profits accumulated by Murphey Company during this period were $109,515.17, adjusted—as agreed to by the parties—for certain items of $1,005.37 to $108,509.80. (R. 27.)

It was stipulated before the Tax Court (R. 28–29):

> It is stipulated between the parties that if the Court finds that the sum of $20,389 represent-

ing the net discount on the redemption of the preferred stock is part of the accumulated earnings or profits of the petitioner, then the amount of the accumulated earnings or profits of the Murphey Co. from February 28, 1913, to September 9, 1938, was $108,509.80; and if the said sum of $20,389 is not a part of the accumulated earnings or profits of the Murphey Co., then the amount of the accumulated earnings or profits to September 9, 1938, was $88,-120.80 (the difference being $20,389.)

The Tax Court found (R. 27):

As of June 30, 1938, the paid-in capital, the paid-in surplus, and the earned surplus of the Murphey Co., were as follows:

Capital paid-in for stock	$125,000.00
Paid-in surplus—cash paid in	47,400.00
Earned surplus, adjusted	108,509.80

Finally, The Tax Court found as a fact (R. 29):

The gain of $20,389 realized by the Murphey Co. upon the redemption of all of its preferred stock is a part of its accumulated earnings or profits, which amounted to $108,509.80 in September 1938.

SUMMARY OF ARGUMENT

Taxpayer accepts the findings of fact made by The Tax Court. Its claim, therefore, is that, as a matter of law, The Tax Court erred in holding that the $20,-389 realized by the Murphey Company from the retirement of its preferred stock at a discount constituted earnings and profits distributable as a dividend within the meaning of Section 115 (g) of the Revenue Act of 1938. However, at the moment the last share of

preferred stock was retired and the capital of the company reduced by its cancellation, the amount of $20,389 became the property of Murphey Company for the benefit of its sole stockholder, the taxpayer, subject to no liability of any kind, stock or otherwise. This sum is over and above any capital investment represented by any outstanding shares, all of which were held by taxpayer. In every real sense it constitutes corporate gain. Acquisition of stock by a corporation, even where not traded by it upon the market, may result in gain. "Taxable corporate income" and "earnings and profits" are not the same. A gain to a corporation resulting from a tax free exchange may constitute earnings and profits and so may other tax free income; deductions permitted against taxable income may not be permitted against earnings and profits. In any event, the transaction is closed; if ever taxable, it must be taxable now. A reversal will afford a facile means of tax evasion.

ARGUMENT

The sum realized by a corporation, upon the purchase and retirement of all of its preferred stock at a discount from par value, forms part of its accumulated earnings and profits taxable to the recipient, its sole stockholder, if distributed at such time and in such manner, as to be essentially equivalent to the distribution of a taxable dividend, within the meaning of Section 115 (g) of the Revenue Act of 1938

The taxpayer accepts in their entirety the findings of fact made by The Tax Court. (Br. 2.) Hence, its claim here must be that, upon these facts as found, as a matter of law, the $20,389 realized by Murphey Company from the retirement of its preferred stock

at a discount can not constitute earnings and profits distributable as a dividend within the meaning of Section 115 (g) of the Revenue Act of 1938. We will show that this position is without foundation.

Unquestionably, the sum of $20,389 constituted part of the assets of Murphey Company and was actually distributed and received by the taxpayer. The Tax Court found as a fact that this sum did not form a part of either "capital paid-in for stock" or "paid-in surplus-cash paid in" (R. 27) and the taxpayer accepts this finding of The Tax Court. Hence, these funds must constitute an increase of and form part of the surplus of the Murphey Company.[2]

Construing the definition of "dividend" contained in Section 115 (a) of the Revenue Act of 1928, not differing in any respect material to the present consideration from the same section of the Revenue Act of 1938,[3] in *Cummings* v. *Commissioner,* 73 F. 2d 477, 480, the Circuit Court of Appeals for the First Circuit said:

> If these funds, however derived, belonged to the Company when received, they would go to increase its surplus, and it cannot be seriously argued that the *surplus funds in the hands of the company over and above its stock liability are not the earnings or profits contemplated by the section.* [Italics supplied.][4]

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[2] Indeed, the Commissioner determined that the item of $20,389 represented "increase of surplus." (R. 14.)

[3] See Appendix, *infra.*

[4] In the cited case the funds distributed as dividends were derived from proceeds of insurance policies taken by the corporation upon the life of its president. The court, thus, supported a broad construction of "earnings and profits."

Certainly there is no stock liability here for this $20,389. The *entire* issue of 2,355 shares of preferred stock, originally sold for a cash consideration of $233,-500 (R. 23, 35), had been repurchased and retired or cancelled at a net price below par, thus leaving this balance of $20,389, included among the assets of the company (R. 28–29). Upon the redemption of the preferred stock the capital of the Murphey Company was reduced proportionately. (R. 35.) The only outstanding shares were the common stock, all belonging to taxpayer. It cannot be claimed that this fund of $20,389 represents any capital contributed for common stock; indeed, as already pointed out, the findings of The Tax Court are to the contrary. (R. 27.) This is not a case of a return to preferred stockholders of capital contributed by them, but distribution to a common stockholder of a fund over and above any sum contributed or invested by it. To paraphrase the language of the cited case, these were surplus funds in the hands of the company over and above its stock liability, belong to the company and form part of its earnings and profits. Since the preferred stock was retired and none was outstanding during the taxable year, this sum was, as The Tax Court found, available to pay dividends on the common shares.

The average man would readily agree that an actual profit was realized. Indeed, it is clearly inferable from the conceded findings that Murphey Company repurchased the preferred stock, when and as it did, in order to obtain this gain. At the moment that the

last share of the preferred stock was retired, and the capital of the company, which the preferred stock represented, was reduced by its cancellation, the amount of $20,389 became the property of Murphey Company for the benefit of its sole common stockholders, the taxpayer, subject to no liabilities of any kind. This is no theoretical question involving a future distribution, but an accomplished payment received by taxpayer during the tax period involved. The taxpayer's contention does not accord with the realities of the situation. Should it prevail in this case, then equally stockholders in receipt under similar circumstances of distributions of $200,000 or $2,000,000 over and above any capital contributed by them may evade tax liability. If this procedure is approved, a facile means is at hand for a company with substantial ready funds, taking advantage of a temporary market decline, to accumulate and distribute to its common stockholders enormous dividends, which the latter may then enjoy, evading their fair share of the tax burden.[5]

In *Morainville* v. *Commissioner,* 46 B. T. A. 753, 760, reversed on other grounds, 135 F. 2d 201 (C. C. A. 6th), the Board of Tax Appeals sustained the Commissioner's contention on facts closely similar to those at bar. There it will be noted that the amount realized by the purchase and retirement by

[5] The purchase at a discount and retirement of preferred stock, during periods of market decline, especially by investment companies, is an accepted financial practice and believed to be a matter of common knowledge.

the corporation of its own preferred shares was very large. The Board said (p. 760):

> Between 1927 and 1935 the company paid for some of its own preferred shares and realized a profit of $1,279,583.80, which apparently has a place in the surplus, and petitioners would have it excluded from the available earnings. It appears only that the shares were purchased and ultimately retired. It is entirely possible that the amount is within earnings and profits from which taxable dividends may be distributed. *Commissioner* v. *Young Corporation,* 103 Fed. (2d) 137; *Allyne-Zerk Co.* v. *Commissioner,* 83 Fed. (2d) 525.

Moreover, from another aspect, the Commissioner's contention of a gain finds additional support. In one of the transactions whereby the preferred stock was purchased and redeemed, the Murphey Company paid a premium of $30 over par value. (R. 28.) This premium was undoubtedly charged against the corporate earnings and profits. Had the purchase of the entire outstanding issue been made at a premium, the corporation would have undoubtedly claimed a corresponding reduction of earnings and profits. See *J. Weingarten, Inc.* v. *Commissioner,* 44 B. T. A. 798, 809, where the Board recently approved a charge against earnings and profits and a credit for dividends paid to the preferred stockholder, receiving the premium. If a charge against earnings and profits of the corporation is sustained, where a premium is paid for preferred stock purchased and cancelled, surely a corresponding credit to earnings and profits

results, when this stock is purchased and cancelled at a discount.

A recent decision of this Court establishes that the acquisition by a corporation of its own stock constitutes gain, *even though the corporation is not dealing with the stock upon the market.* In *Golden State T. & R. Corp.* v. *Commissioner,* 125 F. 2d 641, a wholly owned subsidiary distributed to the taxpayer corporation, there involved, a substantial number of shares of the taxpayer corporation's own stock. The taxpayer corporation, in the cited case, paid its subsidiary no consideration for these shares. This Court held that the acquisition of its own stock by this taxpayer represented corporate gain and was taxable as a dividend, even though the taxpayer corporation had not been dealing with its own shares upon the market. This Court said (p. 642):

> Whether or not the acquisition of shares of its own stock by a corporation is taxable as income depends upon the nature of the transaction and not upon the disposition of the stock after acquisition (*Allyne-Zerk Co.* v. *Com'r,* 6 Cir., 83 F. 2d 525; *Com'r* v. *S. A. Woods Mach. Co.,* 1 Cir., 57 F. 2d 635; *Dorsey Co.* v. *Com'r,* 5 Cir., 76 F. 2d 339; *Com'r* v. *Boca Ceiga Development Co.,* 3 Cir., 66 F. 2d 1004, 1005; Treasury Regulations 77, Art. 66) unless the corporation is dealing with its own shares on the market, in which event the gain is clearly taxable (Treas. Reg. 77, Act of 1932, Art. 66, § 2) the same as in the case of any other stock purchased and sold by it. Thus it appears that it is immaterial whether or not the acquired

> stock becomes treasury stock, either by action of the corporation or by operation of law, if it in fact represents corporate gain.

Moreover, if this gain is not now taxed it will never be taxed. In the case of a tax-free exchange, the recognition of the gain or loss is postponed; but here the stock has been retired, the gain realized and paid over to the stockholder. The shares are not being held in the treasury; they have been cancelled.

The Regulations [6] which the taxpayer quotes in its brief (pp. 5–6) provides only that acquisition, of its own stock by a corporation may not, depending on circumstances, give rise to a "*taxable* gain"; the Regulations do not deny the existence of a "gain." So, in *Commissioner* v. *F. J. Young Corp.,* 103 F. 2d 137, the Circuit Court of Appeals for the Third Circuit held that a gain to a corporation, which resulted from a tax-free exchange of securities, must, nevertheless, be considered earnings and profits out of which a dividend may be declared (p. 139):

> Section 115 (a) is simply a definition of the word "dividend" and merely distinguishes between a distribution out of "earnings and profits" and a distribution out of capital. The words "earnings or profits," as therein used, are words in common use, and "are to be given their natural, plain, ordinary, and commonly understood meaning." 59 C. J. p. 975, section 577; *Miller* v. *Robertson,* 266 U. S. 243, 45 S. Ct.

[6] Regulations 103, Sec. 19.22 (a)–16, promulgated under the Internal Revenue Code, which is the same as Regulations 101, Art. 22 (a)–16, promulgated under the Revenue Act of 1938.

73, 69 L. Ed. 265; *DeGanay* v. *Lederer,* 250 U. S. 376, 39 S. Ct. 524, 63 L. Ed. 1042; *Lake County* v. *Rollins,* 130 U. S. 662, 9 S. Ct. 651, 32 L. Ed. 1060. If Congress had intended to limit the meaning of the word "dividend" to a distribution out of "recognized" gains or out of taxable income, it would expressly have indicated that fact.

Thus, similarly it has frequently been ruled that "taxable corporate net income" and "earnings and profits" are not the same. Items, which do not constitute taxable income to the corporation, may, nevertheless, constitute a part of earnings and profits, taxable as dividends to stockholders, as, for example, interest upon obligations issued by a state, all income exempted by statute, and dividends of domestic corporations. On the other hand, some extraordinary expenses, excessive charitable contributions, federal taxes, and local benefit taxes, not deductible in computing taxable net income, may be deducted in determining earnings and profits. Depletion reserve, based on discovery value substantially in excess of costs, may not be deducted from earnings and profits, in computing taxable dividends, but may be deductible in determining taxable net income. *Weyerhaeuser* v. *Commissioner,* 33 B. T. A. 594, 597; *Ayer* v. *Commissioner,* 12 B. T. A. 284, 287; see also Regulations 101, Art. 115–3 (Appendix, *infra*).

The authorities cited by taxpayer, where not overruled, are not in point. *Houston Brothers Co.* v. *Commissioner,* 21 B. T. A. 804 (Br. 8–9), has been overruled in *Commissioner* v. *S. A. Woods Mach. Co.,*

57 F. 2d 635, 636, in which the Circuit Court of Appeals for the First Circuit said:

> The view taken by the Board of Tax Appeals (see *Houston Brothers Co.* v. *Commissioner,* 21 B. T. A. 804) presses accounting theory too far in disregard of plain facts. It is not supported by any decision which has come to our attention except those of the Board.

To the same effect is the decision in *Commissioner* v. *Boca Ceiga Development Co.,* 66 F. 2d 1004, 1005 (C. C. A. 3d), where the court also pointed out that the Board of Tax Appeals no longer follows its own ruling in the *Houston* case.

The decision of the Board of Tax Appeals in *Liberty Agency Co.* v. *Commissioner,* 5 B. T. A. 778 (Br. 9), involved an issue of taxable income, not a determination of earnings and profits. Finally, in *Commissioner* v. *Inland Finance Co.,* 63 F. 2d 886 (C. C. A. 9th), the facts as well as the issue decided are readily distinguishable from those at bar. There, subscribers to the original issue of the taxpayer corporation's stock made payments on account of instalment subscriptions, but had failed to complete payments in full. It appeared that the agreements were subject to reinstatement at any time at the option of the subscriber and that some of the agreements had been reinstated. The issue was whether these payments on account were taxable income to the corporation. This Court held, first, that the payments on account had not become the absolute property of the taxpayer without qualification or condition,

since the agreements were subject to reinstatement at any time at the option of the subscriber. This Court further held that the forfeited payments did not constitute gain for the purpose of determining *taxable* income. However, as already discussed, "taxable income" and "earnings and profits" are entirely distinct conceptions under the statute and the cited case therefore constitutes no holding, whatsoever, either on the facts or law at bar. Certainly, there was no closed transaction, as in the instant case.

CONCLUSION

The sum of $20,839 realized by the Murphey Company upon the redemption of all of its preferred stock is in every real sense a gain and forms part of its earnings and profits; the stock has been cancelled and retired and the transaction is completed; if a tax is ever to be imposed, it must be imposed now. No formal distinction should be supported, which will open the door to large evasion of sharing the tax burden with others, inherently in the same position. The decision below, so far as appealed from, should in all respects be affirmed.

Respectfully submitted,

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DECEMBER, 1943.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 115–1. *Dividends.*—The term "dividend" for the purpose of Title I (except when

used in sections 203 (a) (3) and 207 (c) (1) thereof) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

* * * * *

ART. 115–3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * *

ART 115–9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely

liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

* * * * *

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